33 Tax Savings in Family Income Planning

Each additional dollar of ordinary income you receive, such as interest, dividends, and rent, is taxed in your highest bracket. If you can deflect income to a lower tax bracket of a child or other dependent relative, he or she will pay a smaller tax on the income than you would pay. However, the tax advantages of shifting income to children under age 14 are sharply reduced by the "kiddie tax"; *see* Chapter 24.

To split income, you must do more than make gifts of income. You must transfer the actual property from which the income is produced. For example, you do not avoid tax on interest by instructing your savings bank to credit interest to your children's account. Unless you actually transfer the complete ownership of the account to your children, the interest income is earned on money owned by you and must be reported by you. The same holds true with dividends, rents, and other forms of income. Unless you transfer the income-producing property, the income will be taxed to you.

You may not split earned income; income resulting from your services is taxed to you. You may not avoid this result by setting up trusts to receive your earned income.

¶33.1 Gift Tax Basics

As family income planning generally requires the transfer of property, you must consider possible gift tax liability. The gift tax rates and credit are the same as those of the estate tax listed in Chapter 39.

Gift tax liability may be avoided by making gifts within an annual exclusion of $10,000 (or $20,000 for joint gifts). To each donee, you may give annually up to $10,000 tax free; furthermore, if your spouse joins in the gift, you may give annually tax free to each donee up to $20,000. The $20,000 exclusion is available even if the entire gift is from your or your spouse's separately owned funds. Thus, if you (with your spouse's consent) make annual gifts to four persons, you could give away without gift tax up to $80,000 (4 × $20,000 exclusion). The $10,000 (or $20,000) annual exclusion is allowed only for cash gifts or gifts of present interests in property; gifts of future interests do not qualify.

Gifts to a spouse who is a U.S. citizen are completely tax free because of the marital deduction. There also is an unlimited gift tax exclusion for paying someone else's tuition or medical expenses, if you directly pay the educational organization or care provider.

If you make an interest-free or low-interest loan to a family member, you may be subject to income tax and gift tax; *see* ¶4.31.

Filing a gift tax return. A gift tax return generally must be filed on Form 709 for a gift made to someone other than your spouse if it exceeds $10,000 or is a gift of a future interest (regardless of value). A return does not have to be filed for gifts qualifying for the tuition or medical expense exclusion.

Married couples who consent to "split" gifts of over $10,000 but up to $20,000 must report the gifts to the IRS, although no gift tax is due under the annual exclusion. If your spouse consents to split gifts with you, you may be able to use a short form, Form 709-A, rather than Form 709; *see* the form instructions.

Form 709 or Form 709-A generally must be filed by April 15th of the year following the year of the gift. If you get a filing extension for your income tax return, the extension also applies to the gift tax return. An additional extension may be granted by the IRS for gift tax returns filed on Form 709 if you show good cause; further extensions are not allowed for filing Form 709-A.

EXAMPLE

In July 1996 Randall Johnson makes a gift of publicly traded stock to his son, Philip, and his daughter, Ann. He gives each of them 1,000 shares of stock valued at $18,500 ($18.50 per share). On Form 709-A, Randall's wife, Claire, consents to split the gifts, thereby doubling the annual exclusion for gifts to each child. Neither Randall nor Claire made any other gifts during 1996. As a result of the gift splitting, no gift tax is due.

If Randall's total gifts for the year to either Philip or Ann exceeded $20,000, the gifts could not be reported on Form 709-A; the longer Form 709 would have to be used.

Even where Form 709 must be filed, gift tax liability computed on the form may be offset by the unified credit applied to gift taxes as well as estate taxes. You and your spouse each have a credit of $192,800 that exempts up to $600,000 of lifetime taxable gifts (exceeding the annual exclusion) from gift tax, *or* transfers of up to $600,000 at death from estate tax. When you report taxable gifts exceeding the annual exclusion, your unified credit offsets the gift tax liability, so that you do not actually have to pay gift tax to the IRS. The portion of the credit used to offset gift taxes indirectly reduces the credit available for estate tax purposes upon your death; *see* the estate tax computation in Chapter 39.

¶33.2 Investments and Custodian Accounts for Minors

A minor generally lacks the ability to manage property. You could create a trust, but this step may be costly. Alternatively, you might set up a custodian account or select property which does not require management and which can be transferred to a minor, such as:

1. Bonds purchased and registered in a minor's name and coupons or the proceeds from the sale or maturity of the bonds deposited in a minor's name.

   See also ¶30.21 for U.S. Savings Bond plan tips. Zero coupon bonds are discussed at ¶30.16 and ¶30.17.

2. Mutual-fund shares purchased and registered in the name of a minor. The problem of management and reinvestment is minimized. Most funds provide for switching investments and automatic reinvestment of dividends for additional shares.

   Tax consequences of college tuition prepayment plans are discussed at ¶33.4.

Custodian accounts. Custodian accounts set up in a bank, mutual fund, or brokerage firm can achieve income splitting; the tax consequences discussed on page 466 generally apply to such accounts. Trust accounts which are considered revocable under state law are ineffective in splitting interest income.

Although custodian accounts may be opened anywhere in the United States, the rules governing the accounts may vary from state to state. The differences between the laws of the states generally do not affect federal tax consequences.

Custodian Securities Account

Purchase of securities through custodian accounts provides a practical method for making a gift of securities to a minor child, eliminating the need for a trust. The mechanics of opening a custodian account are simple. An adult opens a stock account for a minor child at a broker's office. He or she registers the securities in the name of a custodian for the benefit of the child. The custodian may be a parent, a child's guardian, grandparent, brother, sister, uncle, or aunt. In some states, the custodian may be any adult or a bank or trust company. The custodian has the right to sell securities in the account and collect sales proceeds and investment income, and use them for the child's benefit or reinvestment. Tax treatment of custodian accounts is discussed on page 466.

1 Donor's first name and middle initial Randall M.	2 Donor's last name Johnson	3 Donor's social security number 1X1 01 X11X
4 Address (number, street, and apartment number) 914 State Street		5 Legal residence (domicile) State XX
6 City, state, and ZIP code City, State 0X0X0		7 Citizenship USA

8 Did you file any gift tax returns for prior periods? . . . . ☐ Yes ☒ No

If "Yes," state when and where earlier returns were filed ▶

9 Name of consenting spouse Claire Johnson	10 Consenting spouse's social security number X1Z 1X 001X

Note: *Do not use this form to report gifts of closely held stock. Instead, use Form 709.*

List of Gifts

(a) Donee's name and address and description of gift	(b) Donor's adjusted basis of gift	(c) Date of gift	(d) Value at date of gift
1. Philip S. Johnson, son 914 State Street, City, State 0X0X0 Gift of 1,000 Shares of Central Net Corp. common stock (NYSE) at $18.50 per share on 7-10-96. Cusip No. 001005684	$10,000	7-10-96	$18,500
2. Ann C. Johnson, daughter 10 Lincoln Road, City, State 0X0X0 Gift of 1,000 shares of Central Net Corp. common stock (NYSE) at $18.50 per share on 7-10-96. Cusip No. 001005684	$10,000	7-10-96	$18,500

Consent

I consent to have the gifts made by my spouse to third parties during the calendar year considered as made one-half by each of us.

Consenting spouse's signature ▶ Claire Johnson   Date ▶ 3-11-97

Under penalties of perjury, I declare that I have examined this return, and to the best of my knowledge and belief it is true, correct, and complete. Declaration of preparer (other than donor) is based on all information of which preparer has any knowledge.

Donor's signature ▶ Randall Johnson   Date ▶ 3-11-97

Preparer's signature (other than donor's) ▶ Jackie Alan   Date ▶ 3-11-97

Preparer's address (other than donor's) ▶ 200 Adams Lane   City, State 0X0X0

There are limitations placed on the custodian. Proceeds from the sale of an investment or income from an investment may not be used to buy additional securities on margin. While a custodian should prudently seek reasonable income and capital preservation, he or she generally is not liable for losses unless they result from bad faith, intentional wrongdoing, or gross negligence.

When the minor reaches majority age (depending on state law), property in the custodian account is turned over to him or her. No formal accounting is required. The child, now an adult, may sign a simple release freeing the custodian from any liability. But on reaching majority, the child may require a formal accounting if there are any doubts as to the propriety of the custodian's actions while acting as custodian. For this reason, and also for tax record-keeping purposes, a separate bank account should be opened in which proceeds from sales of investments and investment income are deposited pending reinvestment on behalf of the child. Such an account will furnish a convenient record of sales proceeds, investment income, and reinvestment of the same.

Income tax treatment of custodian account. Income from a custodian account is taxable to the child as long as it is not used by the parent who set up the account to pay for the child's support. Tax-exempt income from a custodian account is not taxable to the parent even when used for child support. However, taxable income from a custodian account in excess of the annual income tax floor ($1,300 in 1996) is taxed at the parent's tax rate if the child is under age 14; computation of the "kiddie tax" is discussed in Chapter 24.

Gift tax treatment of custodian account. When setting up a custodian account, you may have to pay a gift tax. A transfer of cash or securities to a custodian account is a gift. But you are not subject to a gift tax if you properly plan the cash contributions or purchase of securities for your children's accounts. You may make gifts of up to $10,000 per person, which is shielded from gift tax by the annual exclusion. The exclusion applies each year to each person to whom you make a gift. If your spouse consents to join with you in the gift, you may give annually tax free up to $20,000 to each person.

If the custodian account is set up at the end of December, another tax-free transfer of $20,000 may be made in the first days of January of the following year. In this way, a total of $40,000 is shifted within the two-month period.

Even if gifts exceeding the $10,000 (or $20,000) exclusion are made, gift tax liability may be offset by the unified credit applied to gift and estate taxes; *see* Chapter 39.

Estate tax treatment of custodian account. The value of a custodian account will be taxed in your estate if you die while acting as custodian of an account before your child reaches his or her majority. However, you may avoid the problem by naming someone other than yourself as custodian. If you should decide to act as custodian, taking the risk that the account will be taxed in your estate, remember no estate tax is incurred if the tax on your estate is offset by the estate tax credit; *see* Chapter 39.

If you act as custodian and decide to terminate the custodianship, care should be taken to formally close the account. Otherwise, if you die while retaining power over the account, the IRS may try to tax the account in your estate.

¶33.3 U.S. Savings Bond Tuition Plans

Because interest on Series EE bonds may be deferred (¶4.29), consider the use of EE bonds to fund part of a college savings program. You can defer the interest until final maturity (30 years) or report the interest annually; *see* ¶30.22. The interest is not subject to state or local tax. For bonds purchased in your child's name, having your child report the interest annually may be advisable where it can be offset by the child's standard deduction or itemized deductions. To the extent interest is offset each year, it escapes tax; *see* ¶4.29.

Interest exclusion may be available if you redeem EE bonds issued after 1989. If you purchase bonds issued after 1989 in your name, or in the joint names of you and your spouse, you may be able to exclude accumulated interest from federal tax if in the year you redeem the bonds you pay tuition and similar education fees. Under current law, the interest exclusion is a limited tax break hedged with restrictions, which may be revised by Congress in future legislation.

Who qualifies for the exclusion. Current law requires you to be age 24 or over before the month in which the bonds are purchased, and the bonds must be issued solely in your name or in the joint names of you and your spouse. You may not claim the exclusion for bonds bought in your child's name, or which you own jointly with your child. In the year the bonds are redeemed, you must pay tuition and similar educational fees for yourself, your spouse, or your dependents. Thus, grandparents may not claim the exclusion if they buy savings bonds to fund the college education of grandchildren unless the children are dependents of the grandparents in the year the bonds are cashed. Tuition and fees must be for a college, university, or a vocational school that meets federal financial aid standards. Room and board are not eligible expenses.

Excludable amount and phase-out rule. The tax-free amount of interest is figured on Form 8815. It depends on the educational expenses and your modified adjusted gross income (MAGI) in the year of the redemption. However, no exclusion is allowed to a married person who files separately, regardless of income or amount of tuition paid.

Educational expenses must be reduced by nontaxable scholarship or fellowship grants or by education benefits paid from a qualifying state tuition prepayment plan (¶33.4). If the redemption amount exceeds the educational expenses, the excludable amount is based on the ratio of expenses to redemption amount. For example, in September 1996, you redeem a $10,000 EE bond issued in January 1990 and receive $7,344, consisting of $5,000 principal and $2,344 interest. If you paid educational expenses of $6,000 in 1996, the excludable percentage of interest is 82% ($6,000 ÷ $7,344). Thus, $1,922 (82% × $2,344) of the interest is potentially excludable from income, subject to the phase-out rules.

A full interest exclusion is allowed only to persons with MAGI below a phase-out threshold. For 1996, a new law changes the way

the threshold and the phase-out range is figured. The 1996 amounts had not been officially released when this book went to press, but the following MAGI phase-out ranges have been estimated: $74,200 to $104,200 for married persons filing jointly and $49,450 to $64,450 for unmarried persons. Married persons filing separately do not qualify. For purposes of applying the phaseout, MAGI is generally your regular adjusted gross income *plus* the interest on the redeemed EE bonds and foreign income items which you excluded from income. *See* the Form 8815 instructions and the Supplement for an update on the phase-out rules.

¶33.4 State Sponsored College Tuition Prepayment Plans

With college costs soaring, several states have set up prepayment plans offering parents a hedge against tuition cost increases. A typical plan allows a parent to prepay tuition costs, even though the child will not start college for 10 or more years. Prepayments are made to a state trust which holds and invests the fund until the child reaches college age. The parent's prepayment covers the tuition, regardless of how much tuition has increased in the interim. A refund, less an administrative fee, is allowed if the state ends the plan, the child is not admitted, decides not to attend college, or dies. Some plans allow part of the prepayment to be used for out-of-state colleges.

A new law effective in 1996 provides tax rules for qualifying state tuition programs. Upon entering college, the student will be taxed on the excess of withdrawals from the plan to pay tuition (and fees, books, and supplies) over the contributions made to the plan on his or her behalf. If a child does not enter college and a refund is made to the parent or other contributor, the refund will be taxable to the extent that it exceeds the contributions made. Contributions to the plan by a parent or other relative are exempt from gift tax.

Parent's legal obligation to provide college education. Under grantor trust rules, a parent making a tuition prepayment could be taxed on trust income if under state law there is a legal obligation to provide the children with a college education. The IRS ruling did not raise this issue.

¶33.5 Joint Tenancy With Spouse

Owning property jointly with one's spouse seems a reasonable solution to a family estate problem. It is easy to arrange; have both names listed as owners. On the death of one, the surviving spouse becomes sole owner of the property. The property does not pass through the estate, thus avoiding probate and other costs. Furthermore, there is no estate tax on the jointly owned property; one-half is included in the deceased spouse's estate but is not taxed because of the marital deduction.

The principal objection to joint ownership is that it deprives each owner of the ability to direct the transfer of ownership of his or her interest. The owner cannot specify who is ultimately to inherit it or the time and method of inheritance.

Jointly owned property may pass to people whom the couple would not have named as heirs. Assume a married man with no children puts nearly all of his property in his and his wife's joint names and then the couple is in an automobile accident that is fatal to the husband. His wife survives for a few weeks, taking full title to the jointly owned property. Upon her death, under local law, all her property passes to her brothers and sisters unless she provides otherwise by will. The husband might have wanted to assure his parents of support for their lives. The survivorship feature of joint ownership cannot be changed once a joint owner dies.

¶33.6 Trusts in Family Planning

You establish a trust by transferring legal title to property to a trustee who manages the property for one or more beneficiaries. As the one who sets up the trust, you are called the grantor or settlor of the trust. The trustee may be one or more individuals or an institution such as a bank or a trust company.

You can create a trust during your lifetime or by your will. A trust created during your lifetime is called an *inter vivos* trust; one established in your will is a testamentary trust. An *inter vivos* trust can be revocable or irrevocable. An irrevocable trust does not allow for changes of heart; it requires a complete surrender of property. By conveying property irrevocably to a trust, you may relieve yourself of tax on the income from the trust principal. Furthermore, the property in trust usually is not subject to estate tax, although it may be subject to gift tax. A trust should be made irrevocable only if you are certain you will not need the trust property in a financial emergency.

Trust income. Where a child is a trust beneficiary, the child reports distributable net trust income as taxable income . If the child is under the age of 14, distributable net income is subject to the "kiddie tax" of ¶24.3. Income that is accumulated for the benefit of a minor child is generally not taxable and, thus, not subject to the kiddie tax.

Revocable Trusts

In a revocable trust, you retain control over the property by reserving the right to revoke the trust. As such, it is considered an incomplete gift and offers no present income tax savings. Furthermore, the trust property will be included as part of your estate. But a revocable trust minimizes delay in passing property to beneficiaries if you die while the trust is in force. When you transfer property to a trust, the property is generally not subject to probate, administration expenses, delays attendant on distributions of estates, or claims of creditors. The interests of trust beneficiaries are generally more secure than those of heirs under a will because a will may be denied probate if found invalid.

Short-term trusts. Before the tax laws were changed in 1986, 10-year (Clifford) trusts were widely used to shift income to relatives in lower tax brackets. Where a trust met the 10-year exception, trust income was taxed to the beneficiary, usually a minor child. Another type of trust used for income splitting was the spousal remainder trust set up for less than 10 years. It allowed income shifting to a child beneficiary when the trust property went to the grantor's spouse after the end of the trust period.

Under current law, both types of trust may no longer be used to shift income to the income beneficiary. Only 10-year trusts created before March 2, 1986, continue to shift income to the income beneficiary. However, tax savings may be nullified for trust beneficiaries under the age of 14 by the kiddie tax. For example, in 1996, unearned income over $1,300 of a child under age 14 is taxed to the child at the top marginal rate of the parents; *see* ¶24.3.

Pre-March 2, 1986, 10-year trusts continue to shift income and provide tax savings to trust beneficiaries age 14 or over.

Spousal remainder trusts have been neutralized as tax-saving techniques by current law that treats the grantor as holding a reversionary interest held by his or her spouse. This spousal attribution rule applies to a reversionary interest of a spouse who marries the grantor after the trust is created.

The current tax rules apply to trust transfers made after March 1, 1986. An exception applies to a 10-year trust created pursuant to a binding property settlement entered into before March 2, 1986, which required the taxpayer to establish a grantor trust.

Grantor trusts. The grantor of a grantor trust is taxed on the income of the trust. A trust is treated as a grantor trust where the grantor has a reversionary interest (at the time of the transfer) of more than 5% of the value of the property transferred to the trust. Under an exception, a grantor is not treated as having a reversionary interest if that interest can take effect only upon the death before age 21 of a beneficiary who is a lineal descendant of the grantor. The beneficiary must have the entire present interest in the trust or trust portion for this exception to apply.

Tax rates for trusts and estates. The following rates apply to taxable income of trusts and estates for taxable years beginning in 1996.

If Taxable Income Is Over:	*The Tax Is:*
$0 but not over $1,600	15% of taxable income
$1,600 but not over $3,800	$240.00 *plus* 28% of excess over $1,600
$3,800 but not over $5,800	$856.00 *plus* 31% of excess over $3,800
$5,800 but not over $7,900	$1,476.00 *plus* 36% of excess over $5,800
over $7,900	$2,232.00 *plus* 39.6% of excess over $7,900

¶33.7 Gifts of Appreciated Property

Making a gift of appreciated property that will eventually be sold may reduce income tax. To shift the profit and the tax, the gift must be completed before the sale or before the donor has made a binding commitment to sell. By making a gift of interests in the property to several family members, it is possible to spread the profit and the tax among a number of taxpayers in the lowest tax bracket. Note: The IRS may claim that the gift was never completed if after sale the donor controls the sales proceeds or has the use of them.

Do not make a gift of property which has decreased in value if you want a deduction for the loss. Once you give the property away, the loss deduction is gone forever. Neither you nor your donee can ever take advantage of it. The better way is to first sell the property, get a loss deduction, and then make a gift of the proceeds.

Transfers of Appreciated Property

Before making a gift of appreciated property, consider the fact that the appreciation on property passed by inheritance escapes income tax; the heir takes a basis equal to estate tax value, which is usually the fair market value at the date of death. Furthermore, appreciated property encumbered by a mortgage may result in income tax to the donor when a gift of the property is made; *see* ¶31.16.

¶33.8 Splitting Business Income With Your Family

Tax on your business income may be reduced if you can shift it to members of your family. If you keep within the annual gift tax exclusion for each donee, there will be no gift tax consequences. However, the estate tax advantages of "estate freeze" techniques has been limited, making it difficult to avoid estate tax on the appreciation in capital interests transferred to children; *see* ¶39.7.

Business income may be shifted by forming a family partnership or by making your family stockholders in a corporation. An S corporation in which stockholders elect to report income may be used

more freely than a partnership to split income.

A minor child will not be recognized as a partner unless he or she is competent to manage his or her own property, or control of the property is exercised by another person as fiduciary for the minor's sole benefit. Here, a trust may be set up to hold the minor's partnership interest. The IRS may review not only the terms of the trust and the partnership agreement but also actual operation of the trust to make certain the grantor-partner has not retained any ownership rights over the interest he or she transferred.

Transfers of stock to a trust for a minor terminate an S election, unless the trust is a qualified trust. For this purpose, a "Subchapter S trust" may be used. Alternatively, stock may be transferred for the minor's benefit to a custodian account for which the parent may act as custodian.

In order to get the income-shifting benefits from setting up a stock custodian account, there must be a *bona fide* transfer of stock entailing a complete surrender by you of any control over the transferred stock.

With a partnership, shifting income may be more difficult, depending on whether capital is a material income-producing factor in the business. If it is, a gift or sale of a partnership interest to a family member is effective. But in a service partnership—real estate or insurance brokers, for example—a mere gift of a partnership interest to a family member will not shift partnership income unless the person actually performs services for the partnership. In one case, the Tax Court held that where substantially all of a family partnership's capital consists of borrowed funds guaranteed by family members, the family partnership interests may be disregarded on the grounds that the borrowed funds are not a material income-producing factor in the business.

In an S corporation, pass-through items must reflect the value of services rendered or capital contributed by family members of the shareholders. If a relative of an S corporation shareholder performs services for or loans money to the corporation without receiving reasonable pay or interest, the IRS may allocate income to reflect the value of the services or capital provided. The "family" of an individual includes only spouse, ancestors, lineal descendants, and any trusts for the primary benefit of such persons.

Payment of wages to your child. Wages paid to your child are not subject to the "kiddie tax" of ¶24.3, but investment income earned by the child from investing those wages is subject to the "kiddie tax." You may also deduct the wages as a business expense if the payments are reasonable. Set the wages at the scale that you would pay an outsider; keep records of the child's work; withhold tax; and provide the child with a Form W-2. If the child is age 17 or under, you do not have to withhold FICA taxes on the wages. FICA taxes are due on wages paid to a child age 18 or over.

¶33.9 Life Insurance Offers Tax Advantages

Insurance may provide a tax-free accumulation of cash. During the time you pay premiums, the value of your contract increases at compound interest rates. The increase is not subject to income tax. In addition, when your policy is paid at death, the proceeds are not subject to income tax.

Estate tax planning. To shelter life insurance proceeds from estate tax, you must not have ownership rights in the policy. If you have an existing policy, you must assign your ownership rights such as the right to change beneficiaries, the right to surrender or cancel the policy, the right to assign it, and the right to borrow against it. An assignment must occur more than three years before death to exclude the proceeds from your estate.

COURT DECISION

Policy Owned by Beneficiary

If you are buying a new policy with yourself as the insured, and you want to keep the proceeds out of your gross estate, you must buy the policy in another's name, such as in your spouse's name, or have your beneficiary buy the policy. For example, a daughter applies for a $1 million policy on her father's life and is the policy owner under the terms of the policy. Although the father pays the premiums, the proceeds paid at his death are not subject to estate tax because he never had ownership rights in the policy. In the past, the IRS contested this tax-free treatment, but now agrees to follow court decisions that allow it.

Assigning group-term policies. Group insurance provided by an employer may be assigned. The IRS has agreed to follow a court decision holding that the power to convert a group policy into an individual policy when you leave the company will not subject the group-term insurance proceeds to estate tax. Since the conversion privilege is exercisable only by taking the economically disadvantageous step of quitting, this right is too remote to be considered a retained ownership right in the policy. If other incidents of ownership are transferred, such as the power to name beneficiaries and fix the type of benefit payable, the transfer will remove the policy from your estate.

The substitution of a new group carrier does not jeopardize assignments under a prior carrier.

When you plan to assign a policy, review your gift tax liability on such a transfer. In the case of an assignment of a group policy, the cost of the policy is determined by actuarially apportioning the employer's total premium payment among the covered employees. This is difficult for an individual employee to do, particularly where there are many employees, so the IRS generally allows employees to value the assigned policy using the same tax tables used to determine the amount of the employee's compensation where group coverage exceeds $50,000. *See* the table at ¶3.3. Key employees may not use the table to determine gift tax liability.

You may want to readjust your coverage to meet new family conditions. You can exchange your policies without tax; *see* ¶11.8.

Using a trust to purchase insurance. If you create a trust to carry a policy on your life by transferring income-producing property the income of which is used to pay the premiums, you are taxable on the trust income. Similarly, if your spouse creates the trust to

carry the policy on your life, he or she is taxable on the trust income. This tax rule does not apply to the trust funding of life insurance covering the life of a third party other than your spouse. For example, a grandparent transfers income-producing property to a trust to pay the premiums on a policy on the life of his son. His grandchildren are named trust beneficiaries. The grandparent is not taxed on the income earned by the trust on the transferred property because the trust purchased insurance on his son's life, not his own.

Insurance trust to receive proceeds. A trust may be used to receive insurance proceeds where there is concern that the beneficiary may be unable to manage a large insurance settlement. The trustee may be a bank or a person directed to invest the proceeds and pay income to beneficiaries according to standards provided in the trust. The trustee may be given the discretion to pay out more or less as circumstances warrant. He or she may be directed to terminate the trust when the beneficiaries reach a certain age, or when they demonstrate their ability to manage money. There may also be investment advantages in a trust. The trust investments may yield a higher rate of return than that of an insurance company under a settlement option.

Insurance proceeds are not subject to income tax whether paid directly to named beneficiaries or to a trust.

Single-premium policies. Single-premium policies have been touted as tax-sheltered investments. Companies offer competitive current returns and tax-free appreciation on your investment fund. The name of the policy is descriptive: You make a single-premium payment—$5,000, $10,000, $50,000, or more. Part of the premium goes for life insurance coverage and part towards an investment fund.

However, tax benefits of single-premium and other cash value policies have been cut back, as discussed below.

Universal life insurance plans. Universal life insurance offers tax-free buildup of interest income at current high market rates and on death, tax-free receipt of insurance proceeds. A universal life insurance policy is made up of (1) life insurance protection, and (2) a cash reserve on which interest income accumulates without tax.

Universal life insurance differs from regular whole life in that the interest rate of universal life is pegged to current bond market rates; whole life rates are low, currently about 5%. Furthermore, a universal life policy lets you withdraw the cash reserve if you want to invest it elsewhere and to allocate how much of your premium payment is to cover insurance protection and how much is to go into the cash reserve.

The tax law sets limits on the amount of premiums that may be earmarked for the cash reserve. If these limits are violated, tax-free treatment for the proceeds may be lost. For these limits, check with the company issuing the policy.

A disadvantage of universal life is that you must incur an up-front commission payment which may be 50% or more of the first premium. There may also be a fee for withdrawing the cash reserve. Therefore, before considering a universal plan, determine the possibility that the purchase of term insurance and an investment in money-market funds or long-term bonds may be a better alternative to a universal life plan.

See below for restrictions on cash value policies.

Restrictions on cash value modified endowment policies. Contracts entered into after June 20, 1988, may be subject to tax penalties if they are considered "modified endowment contracts." Generally, a modified endowment contract is a contract that fails to satisfy a technical "seven-year-pay test." A contract fails the "seven-year-pay test" if the premiums paid during the first seven contract years exceed the sum of the net level premiums that would have been paid by that time had the contract provided for paid-up future benefits after the payment of seven level annual premiums.

Amounts received under modified endowment contracts that are not received as an annuity, such as dividends, cash withdrawals, loans, and amounts received upon a partial surrender of the contract, are taxable to the extent the cash surrender value of the contract exceeds the policyholder's investment. Withdrawals that are greater than the excess of cash surrender value over the investment are a tax-free return of capital.

To prevent marketing of multiple contracts as a means of avoiding these tax limitations, all modified endowment contracts issued by the same insurer or its affiliates to the same policyholder within the same calendar year are aggregated to determine the amount includible in income.

For policies *other* than modified endowment contracts, non-annuity withdrawals continue to be tax free until they exceed the policyholder's investment. Assignments or pledges of a contract to cover burial or pre-arranged funeral expenses are not considered taxable distributions if the contractual death benefit is $25,000 or less.

Penalty for early withdrawals from cash value policy. A 10% premature withdrawal penalty applies to taxable distributions and loans unless the policyholder is over age 59½, disabled, or the distribution is one of a series of substantially equal payments over life expectancy or over joint life expectancy with a beneficiary; for further details, *see* ¶7.14.

¶33.10 Losses May Be Disallowed on Sales to Related Persons

A loss on a sale to certain related taxpayers may not be deductible, even though you make the sale in good faith, the sale is involuntary (for example, a member of your family forecloses a mortgage on your property), or you sell through a public stock exchange and related persons buy the equivalent property; see Examples 1 and 2 on the next page.

Related parties. Losses are not allowed on sales between you and your brothers or sisters (whether by the whole or half blood), parents, grandparents, children, or grandchildren. Furthermore, no loss may be claimed on a sale to your spouse; the tax-free exchange rules of ¶6.6 apply.

A loss is disallowed where the sale is made to your sister-in-law, as nominee of your brother. This sale is deemed to be between you and your brother. But you may deduct the loss on sales to your

spouse's relative (for example, your brother-in-law or spouse's stepparent) even if you and your spouse file a joint return.

The Tax Court has allowed a loss on a direct sale to a son-in-law. In a private ruling, the IRS allowed a loss on a sale of a business to a son-in-law where it was shown that his wife (the seller's daughter) did not own an interest in the company. Losses have been disallowed upon withdrawal from a joint venture and from a partnership conducted by members of a family. Family members have argued that losses should be allowed where the sales were motivated by family hostility. The Tax Court ruled that family hostility may not be considered; losses between proscribed family members are disallowed in all cases.

Losses are barred on sales between an individual and a controlled partnership or controlled corporation (where that individual owns more than 50% in value of the outstanding stock or capital interests).

Losses may also be disallowed in sales between controlled companies, a trust and its creator, a trust and a beneficiary, a partnership and a corporation controlled by the same person (more than 50% ownership), or a tax-exempt organization and its founder. Check with your tax counselor whenever you plan to sell property at a loss to a buyer who may fit one of these descriptions.

Related buyer's resale at profit. Sometimes, the disallowed loss may be saved. When you sell to a related party who resells the property at a profit, he or she gets the benefit of your disallowed loss. Your purchaser's gain up to the amount of your disallowed loss is not taxed; *see* Example 5 in the next column.

EXAMPLES

1. You sell 100 shares of A Co. stock to your brother for $1,000. They cost you $5,000. You may not deduct your $4,000 loss, even though the sale was made in good faith.
2. The stock investments of a mother and son were managed by the same investment counselor. But neither the son nor mother had any right or control over the other's securities. The counselor followed separate and independent policies for each. Without the son's or his mother's prior approval, the counselor carried out the following transactions: (1) on the same day, he sold at a loss the son's stock in four companies and bought the same stock for the mother's account; and (2) he sold at a loss the son's stock in a copper company, and 28 days later bought the same stock for his mother. The losses of the first sale were disallowed, but not the losses of the copper stock sale because of the time break of 28 days. However, the court did not say how much of a minimum time break is needed to remove a sale-purchase transaction from the rule disallowing losses between related parties.
3. In calculating the stock owned, not only must the stock held in your own name be taken into account, but also that owned by your family. You also add (1) the proportionate share of any stock held by a corporation, estate, trust, or partnership in which you have an interest as a shareholder, beneficiary, or partner; and (2) any other stock owned individually by your partner.
4. You may own 30% of the stock of a company. A trust in which you have a one-half beneficial interest owns 30%. Your partner owns 10% of the stock of the same company. You are deemed the owner of 55% of the stock of that company (30%, plus one-half of 30%, plus 10%).
5. Smith bought securities in 1980 which cost $10,000. In 1983, he sold them to his sister for $8,000. The $2,000 loss was not deductible by Smith. His sister's basis for the securities is $8,000. In 1996, she sells them for $9,000. The $1,000 gain is not taxed because it is washed out by part of the disallowed loss. If she sold securities for $11,000, then only $1,000 of the $3,000 gain would be taxed.